AXIAL

Summer 2022

Lower Middle Market Pursuits: 1H Deal Flow Surges

Record-breaking first half demonstrates resiliency as sentiment shifts.

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Quantifying the Grit of the LMM

It's an awfully challenging year to prognosticate on the markets. Rather than join the growing chorus of newly minted macro fortune-tellers, I want to share three interesting data points that emerged from Axial's Summer *Lower Middle Market Pursuits Report*.

Sell-Side Deal Flow Sets New Record

That's right. At a time when closed deal volume is slumping globally, sell-side deal flow on the Axial platform – a proxy for the North American lower middle market – set new records in the first half of the year. While the overall market may be down, Axial as a platform is continuing to grow as a venue where buyers and sellers of lower middle market companies convene. In the first six months of the year alone, there were more than 4,990 new sale processes initiated on the Axial platform, representing an 8% increase over last year's record-breaking first half.

Consumer Goods: Investing in Transformation

Most sectors saw the number of new targets grow versus the second half of last year, underscoring the choice available to prospective buyers. Even the consumer goods sector, facing intensifying headwinds in the form of flailing sentiment, saw new deal flow surge by nearly a quarter in the first half (22%). Rather than representing a contrarian opportunity for retail, the most compelling opportunities revolved around the sector's transformation – DTC manufacturers and distribution companies or packaging-and-label makers who are facilitating this evolution.

Non-Institutional Buyers Step Up

In the past, we've discussed the extent to which private equity investors and investment banks helped fuel the growth of the lower middle market. And while these constituents maintained a significant presence in the first half, more notable were the non-institutional buyers who seem to be increasing in numbers and revealing their creativity. On the buy-side, the proportion of activity attributable to individual investors, independent sponsors, family offices, and holding companies all grew versus the previous year. At a time when most assume the M&A industry has decamped to their summer homes, the activity also underscores the grit of professionals navigating a suddenly uncertain backdrop. Many will continue to be tested in the months ahead.

In the first half, unprofitable tech equities were the first to get creamed, with 80% of the public stocks down 50% or more. Then came the heavily levered crypto marketplace, which formally imploded in June. Just before we went to print, the July inflation report was released, and the numbers continue to head in the wrong direction. Interest rates will continue to rise.

It will be interesting to see if the huge cohort of private equity-backed companies is one of the next shoes to drop, as rapidly rising fuel, labor and operating costs join forces with rising costs of debt and collectively make their way into the P&L of thousands of companies in the second half of 2022. We're all holding our breath a bit.

We'll look forward to sharing our next update in the fall. In the meantime, enjoy summer!

Lower Middle Market: A Source of Light within M&A

By most accounts, the abrupt shift in the economy forced deal makers to put their pencils down in the first half. According to Refinitiv, global M&A was more than a fifth (or 21%) off of its year-ago pace based on the value of closed deals during the first six months. While 2021 presented a difficult comparison given the record-breaking volume last year, the combination of a worsening inflation picture, a hawkish Fed, and public market volatility is contributing to a widening gap between buyer and seller expectations in 2022.

Just to recap, in June, the Consumer Price Index soared to 8.6% year over year, above expectations and reflecting the biggest surge in the headline CPI in over four decades. To address rising prices, the Federal Reserve hiked the Fed Funds rate by 75 basis points that same month. This came on the heels of a half-point increase in May and represented the largest hike from the Fed since 1994. Meanwhile, the S&P 500 was down by 19.96% in the first half, representing the index's worst performance since 1970. And since the S&P was down by more than 20% from its January 3rd peak, the stock market officially entered "bear market" territory.

Against this backdrop, deal makers in the private markets might be expected to embrace a "wait and see" approach. In most years, even when the markets are running on all cylinders, the spring and summer are traditionally a period in which deal activity levels off following a rush of M&A to start the year and ahead of the seasonal peak that generally characterizes Q3. What may come as a surprise to casual observers is that deal makers in the second quarter, rather than ease up amid the uncertainty, instead doubled down to both bring new deals to market and source new transactions. At least this was the case in the lower middle market, where deal flow at the top of the funnel belied any of the turbulence characterizing every other segment of the economy.

WHAT YOU'LL FIND INSIDE:

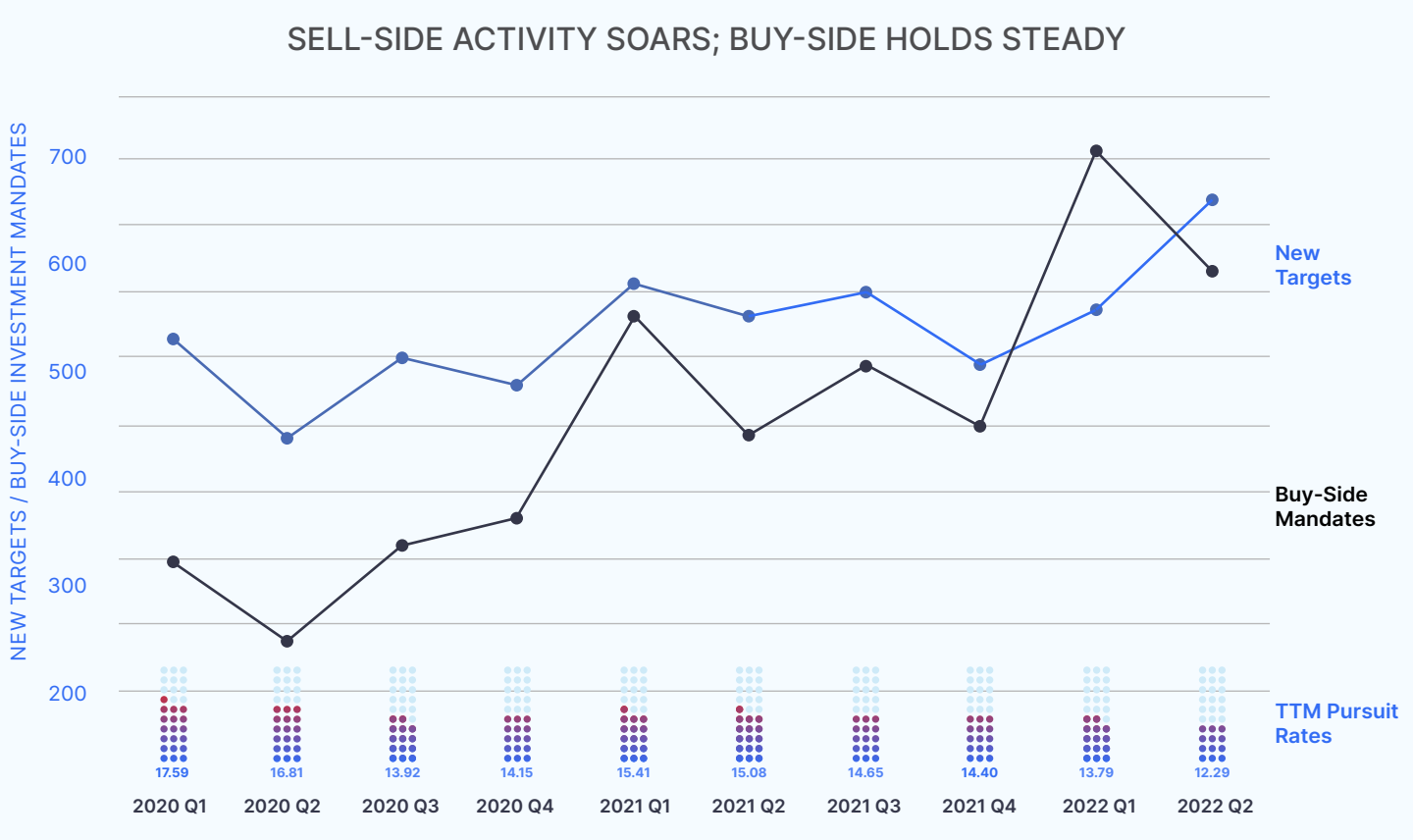
SURVEY OF ONE

Rick Thomas
Chief Executive Officer
FOCUS Investment Banking

In the last few years sellers have had their high expectations met by buyers who had few options but to pay up. Today, sellers are continuing to hold firm, and quality deals are still transacting at premium prices. Buyers may appear less enthusiastic, but the level of activity remains high and there is plenty of capital to deploy, supporting strong valuations for good companies.

Concern about a recession far outweighs worries about rising interest rates. Financial buyers in particular will want to understand the effects of a downturn on the industries they target.

Edited for clarity and brevity.



Quarterly Funnel Flows Overflowing

Based on activity on the Axial platform, sell-side deal flow in the second quarter topped every other three-month period since 2020. This includes the 2021 first quarter, which set the previous highwater mark as sellers who sat on the sidelines during the early stages of the pandemic returned en masse. Year over year, sell-side activity on the Axial platform – a proxy for lower middle market deal flow – surged by 20% in Q2 and increased by 8% in the first half of the year.

On the buy-side, new mandates from prospective acquirers also surged, climbing 35% year over year in Q2. While buy-side activity during the second quarter was well off the record-breaking Q1 pace, the total number of new mandates eclipsed every other quarter over the previous two and a half years. And buy-side activity in the first half ballooned by 30%, year over year.

Previous *Pursuits Reports* highlighted how the lower middle market can be somewhat insulated from global geopolitical challenges, such as the war in Ukraine. Similarly, previous reports also discussed the extent to which available dry powder in private equity, estimated to be in excess of $1.3 trillion according to Preqin, was fueling add-on activity. This, in turn, creates a stabilizing force for M&A in the lower middle market.

But given the surge of activity, versus more of a steady state that might be expected, other factors are at play. Rising interest rates, rather than slowing deal flow, may be accelerating activity. Sellers recognize that as the cost of capital climbs, it will come at the expense of valuations, creating an impetus for buyers looking to transact ahead of future hikes.

Likewise, as economists forecast a coming recession, business owners after two years of growth, may be trying to time their exits ahead of expected headwinds. Keep in mind that baby boomers account for more than two out every five small- to mid-sized business owners. These factors might help explain the late-cycle surge.

Pursuit Rates Reveal a Higher Bar

It's important to keep in mind that the data shared in the *Pursuits Report* represents activity at the top and middle of the deal funnel. So during market dislocations, when buyer and seller expectations begin to bifurcate, new sale processes or buy-side mandates won't necessarily translate into closed deals. And based on the trailing 12-month pursuit rates as of the end of the second quarter, it's clear that prospective acquirers have indeed become more discerning over the past year. The average pursuit rate of 12.29% across all available targets as of the end of Q2 represents the lowest reading of the metric over the past two and a half years.

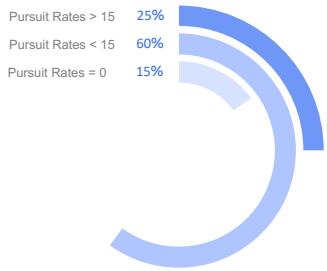
For the uninitiated, pursuit rates track the level of buyer interest in assets marketed over the Axial platform. The metric for each target company climbs as prospective acquirers solicit more information and show interest in specific assets. Informally, pursuit rates above 15% tend to signal elevated interest among buyers, while pursuit rates below this threshold trail the longer-term average. Typically, though, a higher volume of available companies can weigh down the index, as buyers gravitate to the very best assets while overlooking less-than-pristine targets.

Based on the proportion of targets boasting pursuit rates above the 15% index, it is clear prospective acquirers have become more discriminating compared to last year. In 2021, 37% of all available targets generated pursuit rates above the index. In the first half, the number fell to only a quarter. The proportion of assets generating no interest from buyers, with pursuit rates of 0%, also grew to 15% of all available targets in the first half, which was up slightly from 2021.

Of note, the slump in pursuit rates wasn't attributable to a lack of quality. In fact, across all available targets, the average profit margin of 16.22% was comfortably above the 2021 average by more than 150 basis points. Nearly half of all targets (45%) had profit margins exceeding 20%. That being said, prospective buyers – perhaps anticipating a potential liquidity crunch – were drawn to the targets that produced the most earnings. In the first half, companies generating EBITDA in excess of $5 million annually had an average pursuit rate of 16.7%.

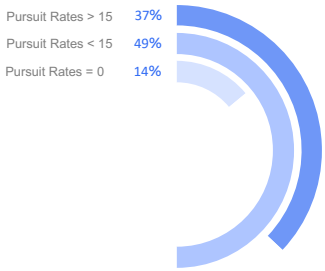
1H 2022 PURSUIT RATE DISTRIBUTION

% of Targets Attracting Pursuit Rates Above and Below the Index



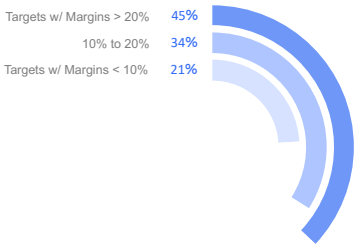
2021 PURSUIT RATE DISTRIBUTION

% of Targets Attracting Pursuit Rates Above and Below the Index

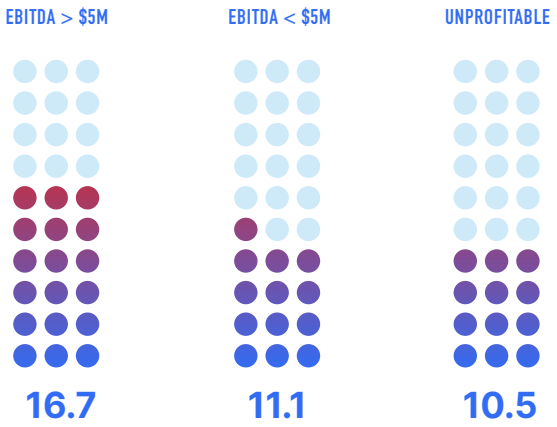


TRACKING QUALITY

% of new Targets in 1H based on Profit Margins



SEEKING STABILITY THROUGH EARNINGS



SELL-SIDE STANDOUTS AND SLUMPERS*

Sectors Showing the Biggest Sequential Increases in Q2 (vs. Q1)

Healthcare: 104%

Food & Hospitality: 84%

Transportation: 74%

Sectors Showing the Biggest Sequential Declines in Q2 (vs. Q1)

Industrials: -24%

Energy & Renewables: -9%

Business Services: -7%

Sectors Showing the Biggest Increases in proportion of total deal flow (1H, 2022 vs. 2H 2021)

Technology: 15% vs. 13.4%

Consumer Goods: 15.1% vs. 14.1%

Financial Services: 1.9% vs. 1.3%

*Minimum of at least 10 new targets each quarter / half

Usual Suspects Spur Sell-Side

The M&A markets, generally, aren't a great proxy for risk-on/risk-off sentiment. Deal processes can be months or years in the making in the lower middle market and during periods of volatility; what's hot in January may be out of favor by July. Yet, at the very top of the deal funnel, sellers do indeed seem well attuned to the shifts in the market and appear eager to align new processes with developing tailwinds.

Operators in healthcare can now point to normalized growth trends.

New processes in healthcare, for instance, more than doubled in Q2 versus the first quarter, as sellers looked to capitalize on the industry's perceived safety and its "acyclical" attributes. Also, more than a year removed from the lockdowns – during which time patients were putting off elective surgeries – operators can now point to normalized growth trends. Among the sellers fetching the highest pursuit rates during the quarter were manufacturers of eyewear, nitrile gloves, and surgical equipment as well as lab-testing providers, informatics companies, and physician practices.

Similarly, the second quarter saw a pronounced jump in the number of food and hospitality companies coming to market. While a portion would fall into the consumer discretionary category (think restaurants, spas, and boutique hotel chains), most qualify as consumer staples, selling everything from frozen seafood and baking ingredients to super-premium spirits, pickles, and ethnic foods.

The growth in transportation reflects ongoing momentum that began in the second half of last year as the supply chain crisis created demand for third-party logistics operators, trucking companies, and other transportation platforms. Meanwhile, it's also worth noting that while industrials, energy, and business services companies saw sequential declines in new processes during Q2, each of these sectors were up during the first half of the year sequentially (versus 2021's second half).

Pursuit Rates: Scratching a Niche

Pursuit rates were generally down across most sectors. As noted in previous reports, it's not uncommon that as sell-side volume climbs – and buyers navigate a more expansive universe of targets – they'll direct their attention to either the most attractive candidates, based on fundamentals, or unique targets, solving very distinct problems.

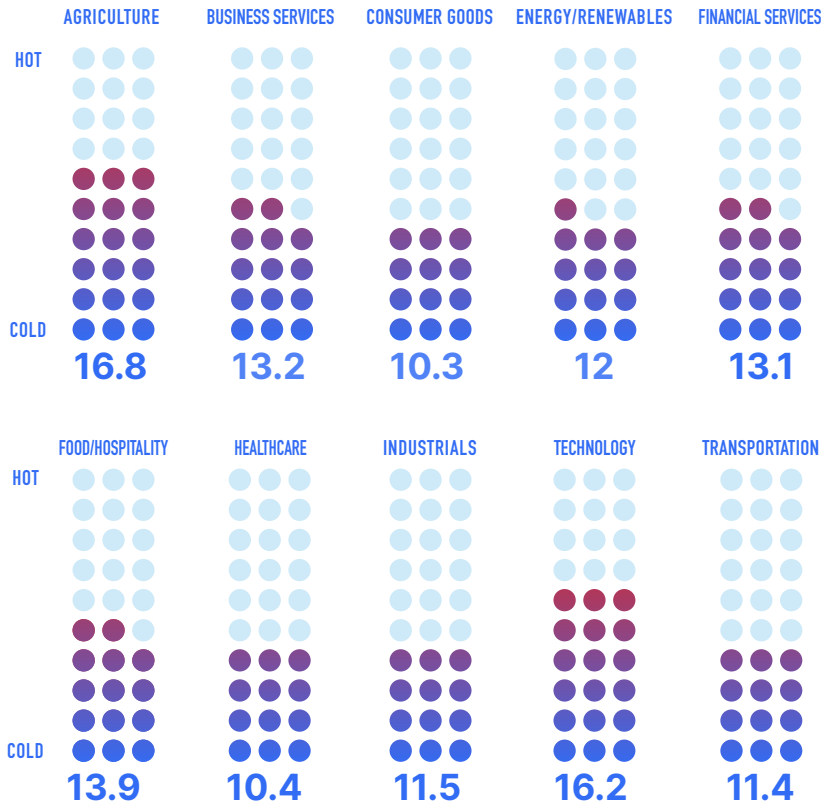
The agriculture sector, for instance, accounted for barely one percent of the total sell-side deal flow in the first six months of the year, but nearly half of all the targets in the sector (46%) generated pursuit rates higher than the 15% index. The most popular niche, based on prospective buyer activity, was the fertilizer and soil-amendment segment, an area that has been disrupted by the war in Ukraine and is expected to grow in the years ahead.

Nearly half of all targets in the agriculture sector generated pursuit rates higher than the 15% index.

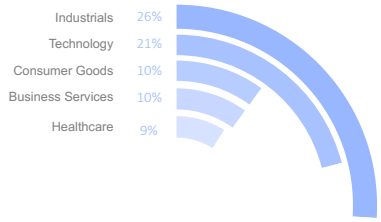
Technology, the only other sector boasting pursuit rates above 15% on a TTM basis, has been among the most consistent areas in terms of buyer interest. Given the growth in multiples in recent years – not to mention the sector's steady performance throughout the pandemic – prospective buyers may be trying to capitalize on the economic turbulence to find value in the sector.

Elsewhere, the industrials had the most targets with pursuit rates above 15%, attributable to the sector's disproportionate amount of deal flow compared to other industries in the lower middle market. However, sectors benefitting from more defensive attributes – such as business services, financials, and less cyclical food and hospitality names – had elevated pursuit rates versus other categories.

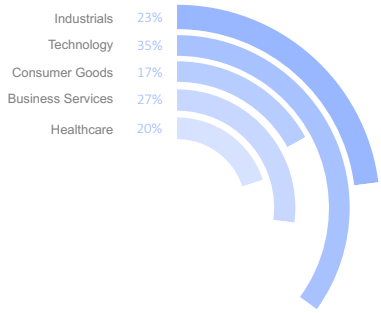
PURSUIT RATE BY SECTOR (TTM)



1H: % of all Targets with Pursuit Rates above the Index (>15%)



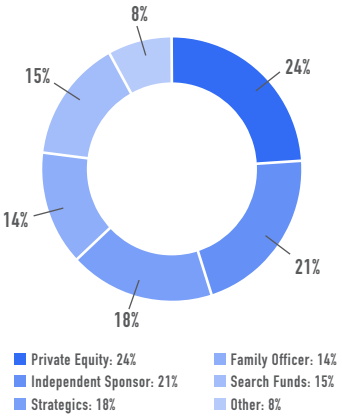
1H: % of Targets within Each Sector with Pursuit Rates above the Index (>15%)



Buy-Side Activity Underscores a Buyer's Market

Activity on the buy-side mostly aligns with sell-side deal flow with a notable exception. Healthcare was the only sector to see its total number of buy-side mandates shrink compared to the last six months of 2021, experiencing a drop-off of 12% sequentially in the first half. To a certain degree, this reflects a challenging comp, as new buy-side mandates in healthcare grew by nearly 20% year over year in 2021, with a pronounced acceleration of activity in the second half accounting for nearly all of the growth. At the same time, the decrease from the first quarter to the second quarter of 2022 stands in sharp contrast to the sell-side activity in healthcare, where the number of new targets more than doubled.

THE BUY-SIDE PLAYERS
(% OF NEW MANDATES)



But again, healthcare was an exception and every other sector experienced considerable growth in buy-side activity during the first half of the year. Most notably, the industrials sector saw its total share of all new buy-side mandates grow from 33% to 37% in the first six months of 2022. In looking at the categories of buyers initiating these efforts, strategic activity on the part of corporations and holding companies was disproportionately higher in industrials than most other sectors – accounting for 20% of all new mandates in the first half.

This shouldn't be unexpected given the surge of industrial manufacturing deals completed last year, as M&A tends to beget more M&A. Smaller tuck-in transactions, particularly if they're secured outside of a formal auction, can add scale, ease supply chain challenges, and improve pricing power, all while being accretive to the bottom line.

Perhaps less expected was the growth in new mandates targeting consumer goods companies. New buy-side efforts in the sector soared 42% in the first half. Again, the nature of the interested buyers can be revealing. While private equity investors and strategics were less active in the sector – at least compared to other areas – interest from individual investors and family offices made up the difference. Given the longer-term timelines of individuals and family offices, investment activity may be opportunistic in nature to find value in a buyer's market. Or it may reflect the Peter Lynch chestnut to "invest in what you know."

BUY-SIDE STANDOUTS

Sectors showing the biggest increases in proportion of new mandates (1H, 2022 vs. 2H 2021)

FASTEST GROWERS

Industrials: 37.8% vs. 33.2%

Consumer Goods: 17.1% vs. 16.1%

Agriculture: 1.0% vs. 0.5%

INDUSTRY DRILLDOWN

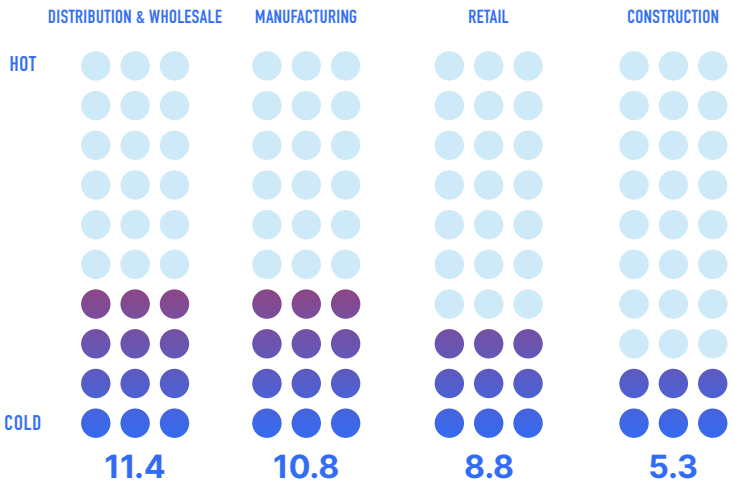
Consumer and Buyer Sentiment Diverge

The consumer goods space, given the developing headwinds, deserves a closer look. In June, the University of Michigan's consumer sentiment index sank by 14% from May to reach its lowest-ever recorded value. Inflation, flailing expectations for future business conditions, and deteriorating assessments of consumers' own financial situations each contributed to the gloomy outlook. So what, exactly, is fueling activity in the sector?

Sell-side deal flow in consumer goods grew by more than 22% in the first half of 2022 over the previous six-month period, while the number of new buy-side mandates in the sector ballooned by 42% over the same timeframe. Looking at pursuit rates data, however, shows a distinct break between the assets generating interest among buyers and those being spurned. Within retail, for instance, only a handful of new targets generated pursuit rates above 15%, but those that did operate in either the discount segment (ie, a golf-liquidation retailer and a closeout business) or sell luxury, high-end goods, which is an area traditionally immune to recessionary pressures.

Previous *Pursuits Reports* have highlighted the budding interest in manufacturers and distribution companies active in the direct-to-consumer space. And these assets continue to be in demand. However, manufacturers of packaging and labels are generating nearly as much interest, underscoring the opportunities now emerging as the consumer space transforms. In fact, the manufacturing and distribution & wholesale categories accounted for 41% and 28% of all buy-side mandates in the first half, respectively, versus retail, which barely accounted for 5%.

TTM PURSUIT RATES



SURVEY OF ONE

Carl Cordova,
Managing Director,
Auctus Capital Partners

Q. The consumer space was among the more active areas. What's driving activity?

A. *Many sellers are trying to find "healing capital" for the lasting wounds of the COVID era, while others are putting expansion plans in place that were delayed by one to three years. Buyers probably made too many allowances in judging Covid-era results 12 to 24 months ago, but have recently become much more demanding.*

Q. What are the outside factors influencing buyer and seller sentiment?

A. *Current events have affected sentiment more than the aftereffects of the pandemic, including supply chain issues, consumer sentiment, energy costs, and rising interest rates. For example, in the food and beverage sector, the cost of goods sold have soared in the last six months and are expected to ascend higher before they decline. This is particularly the case in segments reliant on commodities affected by the war in Ukraine, such as baked goods. Generally, both buyers and sellers are highly concerned about these trends.*

Q. DTC brands, based on pursuit rates, continue to attract investor interest. What are the primary draws to investors?

A. *The major attractions are better control of the customer relationship and brand management. Brands can control what the consumer sees and also capture highly valuable information on their shoppers.*

Q. Your background is in the food and beverage space. What factors might provide optimism in this segment in particular?

A. *There are several big themes in the sector that should have recession-resistant qualities, including: the growth of ethnic food; the continued resurgence of "cocktail culture;" the emergence of protein and meat alternatives; growing demand for innovative spice combinations, dips, and sauces; and expansion in the non-alcoholic beverage category providing unique flavors, clean ingredients, and functionality.*

Responses have been edited for clarity and brevity.

BUYER DRILL DOWN

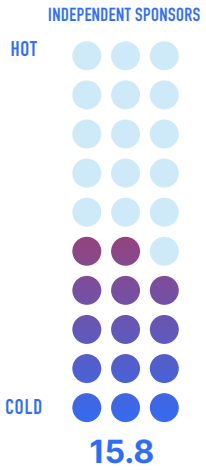
Independent Sponsors Remain Hungry

When marketwatchers consider what's to come in M&A over the balance of the year, many will point to the dry powder available in private equity or the cash reserves on corporate balance sheets for signs of optimism. An overlooked driver and potential X-factor is the outsized role of independent sponsors.

In fact, across all buyer types, independent sponsors accounted for more than a fifth of buy-side mandates in the first half of the year. That's not to say they're not discerning. Independent sponsors, generally, more closely resemble private equity investors – with a buy-side pursuit rate of 15.8% – versus strategics or search funds, with pursuit rates north of 18%. The fact that independent sponsors have also closed more deals than any other category of acquirer, accounting for over 30% of all transactions completed over the Axial platform on a TTM basis, demonstrates the earnestness with which these buyers approach negotiations and helps debunk perceptions about execution risk.

In an uncertain environment, the conventional wisdom might suggest independent sponsors are at a disadvantage to PE firms with a blind pool of capital. But this view ignores the extent to which the flexibility of the independent sponsor model works in their favor. They're not beholden the arbitrary timelines of a fund and can pursue more creative deals that might fall outside of a traditional PE mandate. Independent sponsors also have more flexibility in arranging terms with sellers, which can help bridge a gap in a volatile market and underscores the reliability of most operators in the category.

BUY-SIDE PURSUIT RATE (AS OF Q2, 2022)



SURVEY OF ONE

David Eshaghian
Founder and CEO
Panther Equity Group

Q. Based on the data, independent sponsors seem to be particularly resilient in terms of buy- and sell-side activity. What is fueling this activity?

A. *Great question. Independent sponsors can be highly active, particularly in the lower middle market, as opportunities below the $10 million EBITDA level – especially within the $3 million to $7 million EBITDA range – are more founder or entrepreneur driven.*

The presence and role of independent sponsors is helpful, as founders time their 'exit' less so based on market dynamics. They're generally more motivated by life changes, such as retirement, liquidity needs, or to de-risk their personal wealth (so it's not all tied up in the equity value of their companies).

Q. What are some factors that perhaps speak to the consistent level of activity from this segment of the market?

A. *These dynamics, in which deal flow is driven by personal needs, creates a continuous 'top of funnel' replenishment versus 'upstream' deals, which tend to be more 'sponsor-to-sponsor' driven and are more sensitive to interest rates, macro developments affecting the capital markets, public equity comps, and other factors.*

Q. How has the opportunity set changed for independent sponsors compared to other buyers or sellers in the market?

A. *Independent sponsors continue to become a larger buyer class in the private equity community as capital represents less of a 'barrier to entry' as it did five to 10 years ago. You're seeing this in the equity, credit and family office segments. There are many institutional groups solely focused on supporting independent sponsor (IS) transactions.*

The capital market opportunity for the IS universe continues to grow which in turn, allows for more comfort among sellers and their bankers for independent sponsors. This is especially the case for IS acquirers with deal history.

Responses have been edited for clarity and brevity.

SELLER DRILL DOWN

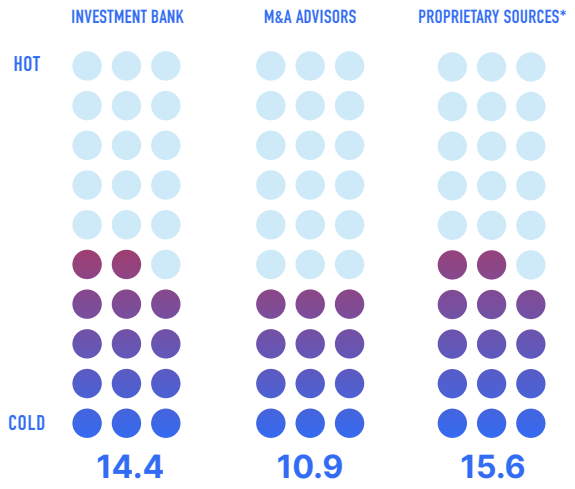
Proprietary Sources in Demand

One of the many draws of the lower middle market is that it's one of the few corners left where proprietary deal flow is still available. The market has certainly become more efficient, and the presence of investment banks and advisors has helped to streamline processes and allow less-sophisticated sellers to maximize the value of their companies. But to prospective buyers, there is still nothing more intriguing than a proprietary deal negotiated outside of a formal auction.

Even as TTM pursuit rates were down considerably in the second quarter, new targets emerging directly from business owners, versus third-party intermediaries, collectively generated an average pursuit rate of 15.6%. Sellers, for instance, include corporations and holding companies, investment firms, family offices, individual investors, and other circles of influence, such as law firms who play a matchmaking role.

To be sure, investment banks and advisors account for the majority of sell-side activity on the Axial platform. But what's interesting is that the proprietary deal flow over the past 12 months is generally characterized by targets with higher revenues and earnings on average than all other targets, averaging approximately $22 million and $3.6 million respectively, with slightly higher profit margins as well. In terms of the sources of proprietary deal flow, consultants and corporations produced the highest volume of sell-side activity over the previous 12 months, while activity emanating out of the independent sponsor universe boasted the highest pursuit rates, exceeding 18.6% on a TTM basis.

TTM PURSUIT RATES



SURVEY OF ONE

Jessica Ginsberg,
Managing Director
LFM Capital

Q. Based on pursuits rate data, buyers are intent on finding proprietary deal flow. This isn't necessarily a new trend, but are there other drivers that might be fueling this focus on proprietary opportunities?

A. *Proprietary deals typically remove the element of competition and allow buyers and sellers to work together directly. There is so much noise in the market right now and deals are getting harder to get done, if finding a deal outside of a formal process can remove some of that complexity or help on the valuation front, buyers are all for it.*

Q. From the sellers' perspective, what are the benefits of a narrow or exclusive process?

A. *Business owners are incredibly busy people, especially with all of the challenges in today's market – supply chain disruption, labor shortages, political unrest, rising interest rates and more. A sale process, in and of itself, requires tremendous bandwidth and the more parties involved, the more complex and time consuming it becomes.*

If a seller can narrow the field early, it fosters a much more efficient process. Also, a narrow process can considerably more comfortable for a seller concerned about confidentiality and the wide distribution of sensitive information.

Q. How does the uncertain environment influence proprietary activity?

A. *Uncertain market conditions increase proprietary activity because the "banked" deal market slows down. Bankers are looking to maximize value for clients and may advise waiting to launch a deal.*

By maintaining an active, proprietary deal pipeline, buyers can stay busy nurturing those relationships when deal volume is down. Sellers may also be more open to engaging in proprietary conversations to get perspective on the market and learn about exit opportunities in more difficult times.

Responses have been edited for clarity and brevity.

Availability of Choice Characterizes LMM

If outside observers had to make an assessment of the economy looking at only the buy- and sell-side activity in the lower middle market, they'd be hard pressed to identify any signs of weakness. It goes back to the market's entrepreneurial DNA.

There's surely new challenges that await. As interest rates climb, there will be ripple effects across the M&A ecosystem as the cost of capital climbs even if it helps to mitigate the more immediate inflation threat. At the same time, the lower middle should continue to provide a source of quality deal flow for the more entrepreneurially minded buyers – those with the grit to keep pressing and the creativity to look where others don't.

The caveat, as the data shows, is that more and more buyers are turning to the lower middle market landscape. This creating a more fertile marketplace but also demands more craft and creativity to transact. In other words, it's exactly the type of environment that lower middle market deal professionals were drawn to in the first place.

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